Degussa Market Report

19 August 2016 Economics · Finance · Precious metals

OUR TOP ISSUES

*This is a short summary of our fortnightly **Degussa Marktreport**.*

Debt Monetized En Masse to Fend Off the Euro Crash?

"[T]he main vehicle of saving is the accumulation of savings deposits, the purchase of bonds and life insurance. All such savings are prejudiced by inflation."

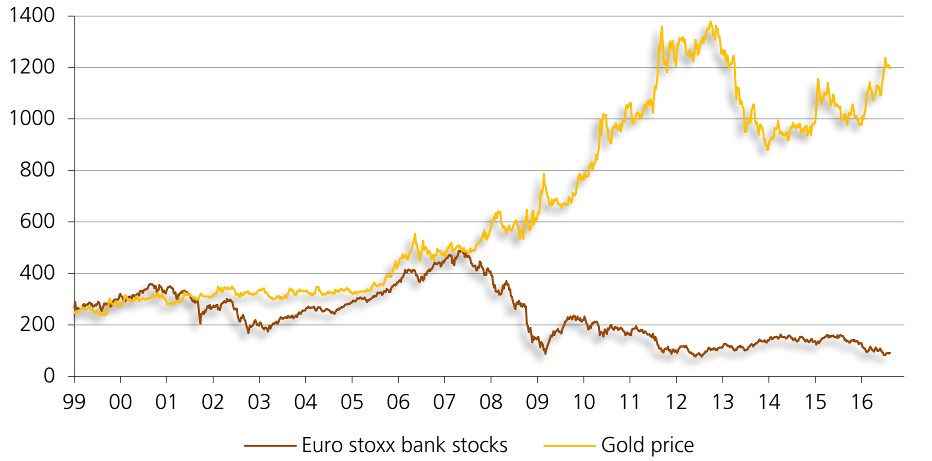
—Ludwig von Mises

Summary:

- **Central banks are bearing down on interest rates and issuing piles of money to prop up a tottering system and fend off the big crash.**
- **But that's not the end of it. They still have plenty tricks in the bag to put off the consequences of wide-scale over-indebtedness.**
- **There's reason to fear that the European Central Bank (ECB) will embark upon the mother of all debt monetization schemes.**
- **Should the ECB indeed open the floodgates, the surging tide of euro money stock will erode the single currency's purchasing power.**
- **The euro probably wouldn't flat-line just yet, but its tumbling value would pose an immediate risk for savers and investors.**
- **And that's why hanging onto gold and buying into companies with inflation-proof business models would seem to be a wise course of action.**

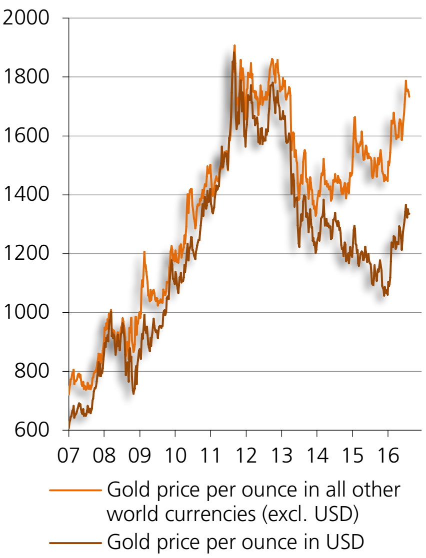
When the international financial and economic crisis hit in late 2007/early 2008, euro area banks' share prices sagged and the gold price (in EUR/oz) soared.

Gold evidently the go-to hedge against the euro crisis
Euro Stoxx bank stocks and the gold price (EUR/oz)



Source: Bloomberg

Price of gold per ounce
in US dollars and all world currencies (excl. the US dollar)*
January 2007 to August 2016

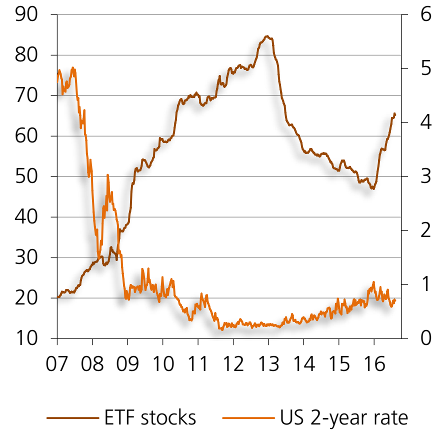


Source: Bloomberg; own calculations
*Calculated from the gold price (USD/oz) and the nominal trade weighted exchange rate of the US dollar. The timeline was indexed at 5 September 2011 with a value of 1.900.

Low rates fuel demand for gold, supporting its price

Since the start of 2016, short-term rates in the US have been retreating. This, in turn, has encouraged the demand for gold as far as gold exchange traded funds (ETFs) are concerned.

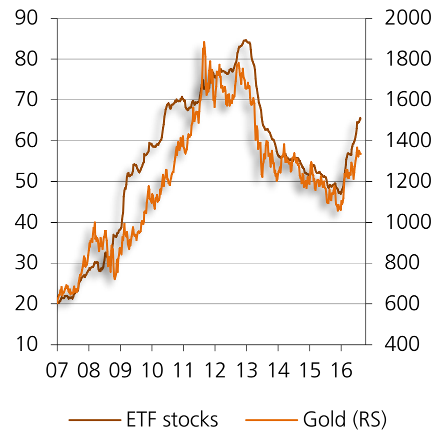
(a) US short-term rates and gold ETFs (in million ounces)



Source: Bloomberg

The rise of ETFs' gold stocks has been accompanied by a rise in the gold price (in USD/oz). As the latest developments would confirm, there is a long-term positive relationship between US short-term rates and the price of gold.

(b) ETF gold stocks (million ounces) and the price of gold (USD/oz)



Source: Bloomberg

That said, there is good reason to expect US interest rates to remain a powerful influence on the price of gold. Likely to stay very low for the foreseeable future, US rates should bolster the price of gold. In other words, chances are that the gold price will edge up.

Confidence in euro area banks plummeted as financing costs took to the skies. Now rising losses in credit and derivative transactions threaten to further diminish banks' already paper-thin equity capital.

The euro banking sector remains in dire straits. Tighter regulation reduces banks' earnings potential. This is aggravated by an ECB policy that favors extremely low interest rates.

Is a renewed euro banking crisis in the offing? Will it be a calamity that lets last year's turmoil look tame? Hard to say, but central banks' actions are sure to figure prominently either way.

'Keep calm and carry on'

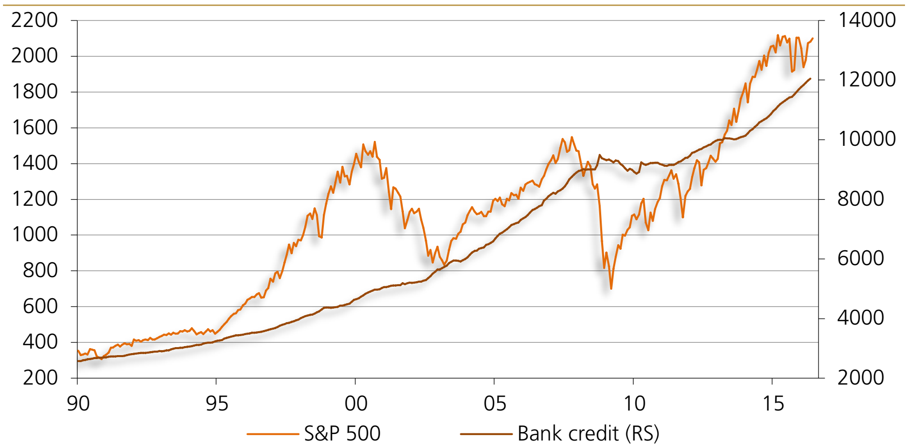
The world's major central banks will go to great lengths to fend off recession and shore up financial markets. And they know exactly where to start: First they must dispel concerns about credit defaults.

Credit makes the financial world go round. Money created by expanding bank credit greases the wheels to propel business activity, drive consumer spending and keep governments rolling.

Central banks need this credit to gush, not trickle, so they slashed interest rates to record lows. And many are busy cranking away at the electronic printing press's virtual handle in the hopes of nursing financially ailing borrowers back to health with the panacea of more and more credit.

Credit supply on the rise, stock prices go up

S&P 500 and US bank credit, in billion US dollars



Source: Bloomberg

Savvy savers and investors will be asking themselves how long this can go on. No one say, but we don't need a crystal ball to see that central banks are the powerful monopolists of money production.

They can expand the money supply anytime and in any amount deemed politically expedient. And that's a fact of monetary life that must be factored into any assessment of the situation in the euro area.

Figure 1 shows (highly stylized) balance sheets of the euro area banking system and the ECB. Numbers are given in billion euros. We crunched these numbers to assess the ECB's capacity for propping up the euro.

Our analysis is based on the following scenario: The ECB buys 4.800 billion euros of government debt (2.900 from euro area banks, 1.900 from non-banks) plus 5.000 billion in bank credit, and refinances 3.800 billion in euro area bank bonds.

Fig. 1.

Assets	Euro area banking sector		Liabilities
Cash	1000	Demand deposits	5800
Credit	17500	Term deposits	5200
thereof: gov't credit	*1100*	Bonds	3800
Securities	4300	Other liabilities	14700
thereof: gov't securities	*1800*		
Other assets	9200	Equity capital	2500
	32000		32000

Assets	ECB		Passiva
Gold	380	Bank notes	1100
Credit to banks	500	Bank deposits	1000
Securities	1600	Other liabilities	1000
Other assets	720	Equity capital	100
	3200		3200

Source: ECB (June 2016); own calculations

Figure 2 shows the outcome of these transactions, which we believe will likely be made at some point. And if this comes to pass, the euro area banking system and the ECB's balance sheets will grow substantially.

Fig. 2.

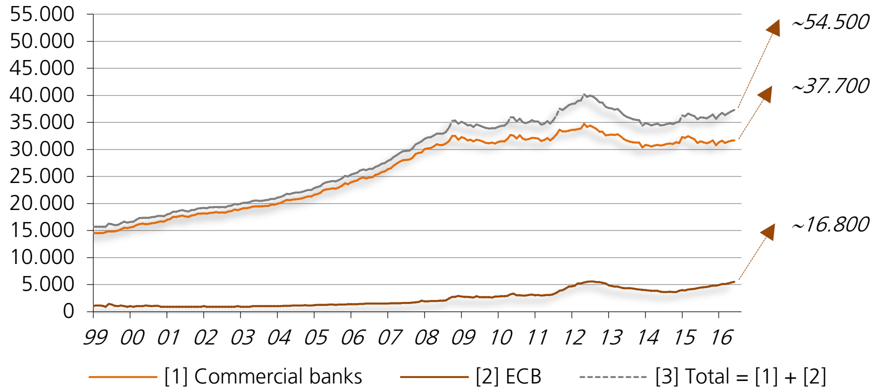
Assets	Euro area banks		Liabilities
Cash	14600	Demand deposits	5800
Credit	11400	Term deposits	5200
thereof: gov't credit	*0*	Bonds	3800
Securities	2500	Other liabilities	14700
thereof: gov't securities	*0*		
Other assets	9200	Equity capital	2500
	37700		32000

Assets	ECB		Liabilities
Gold	380	Bank notes	1100
Credit to banks	4300	Bank deposits	14600
Securities	11400	Other liabilities	1000
Other assets	720	Equity capital	100
	16800		16800

Source: ECB (June 2016); own calculations

ECB's rescue measures likely to have a big impact

Balance sheet volume of euro area banks and the ECB (bn euros)



Source: Thomson Financial; own calculations

The ECB is certainly in a position to buy outstanding debt and churn out new credit to prevent governments and states from defaulting.

However, this would flood the banking system with excess liquidity. The amount of money readily available to pay for goods and services would rise sharply with this high tide of liquidity.

The ECB's rescue measures would thus diminish the euro's buying power, with both its internal and external value probably taking a big hit.

For savers and investors in the euro area, it follows that right now diminished buying power poses a bigger risk than large-scale defaults.

This is another reason why we continue to advocate holding gold and stocks. Gold is the hardest of currencies, and its purchasing power cannot be undermined by adventurous monetary policy.

This gilt metal also serves as insurance against potential payment defaults. In times of extremely low interest rates, gold is a 'natural' substitute for time and savings deposits held with banks.

In view of the inflationary ramifications of central banks' policies, we also believe that holding on to shares in companies with inflation-resistant business models has its merits.[1]

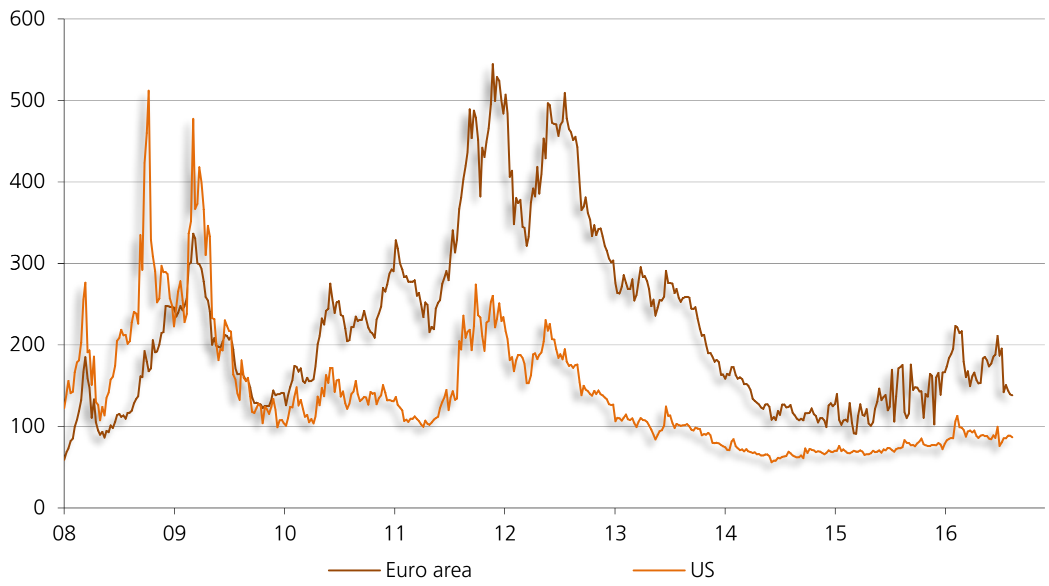
These firms are able to pass the buck by upping their products' prices to compensate for higher input costs, so they can earn positive inflation-adjusted returns on capital even in times of higher inflation.

If investors manage to buy these stocks at low prices—that is, at prices lower than their intrinsic value—they will enjoy a margin of safety that keeps the investment risk in check.

From where we stand, gold and shareholdings in good companies are sound ingredients for a portfolio aimed to weather the storm caused by central banks' monetary follies.

[1] See in this context the classic article from Warren E. Buffet (1977): „**How inflation swindles the equity investor**".

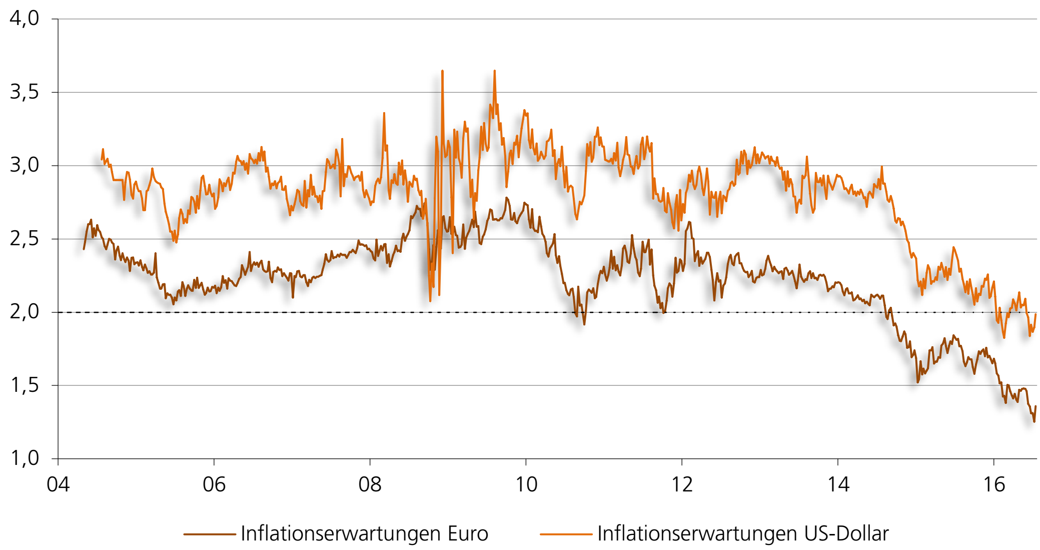
1 Spread for credit default swaps (CDS) on bank bonds*



► The cost of payment default insurance for bank bonds has come down in the euro area in recent weeks. It seems people expect central banks to bail out banks, if necessary

Source: Bloomberg.*5-year maturity, in basis points. At a CDS spread of 100 basis points, it costs 100,000 euros to insure against a payment loss of 10 million euros

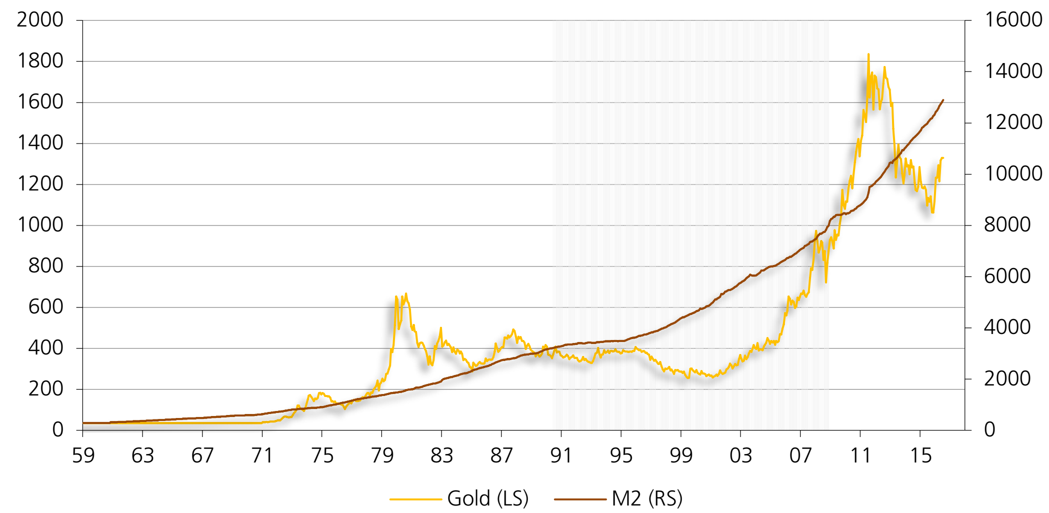
2 Inflation expectations, calculated from financial market prices*



► Inflation expectations have continued to slide in recent months. Financial market players appear to be confident that central banks won't trigger an inflationary cycle anytime soon.

Source: Bloomberg. *Shown here are 5y5y inflation swaps, meaning inflation in five years for the following five years

3 Gold price (USD/oz) and US money stock M2 (in billion US dollars)



► The positive long- term relationship between the price of gold and the US money supply suggests that the price for the gilt metal still has upside potential.

Source: Bloomberg

Precious metals prices, actual and projections (per ounce)

In US-dollar

	Gold		Silver		Platinum		Palladium	
I. Actual	1.346,4		19,5		1.113,2		706,8	
II. Gliding averages								
5 days	1.346,4		19,7		1.117,3		701,5	
10 days	1.343,4		19,8		1.134,4		699,6	
20 days	1.343,2		20,0		1.136,1		701,7	
50 days	1.329,5		19,3		1.078,1		640,1	
100 days	1.289,6		18,0		1.044,7		605,9	
200 days	1.217,0		16,3		971,1		570,6	
III. Projections								
	Rante		Range		Range		Range	
	Low	High	Low	High	Low	High	Low	High
Q3 2016	1.175	1.320	17,6	19,5	850	1.130	640	700
Q4 2016	1.251	1.360	17,1	20,1	800	1.170	660	730
Q1 2017	1.279	1.390	17,8	20,9	1.040	1.220	700	760
Q2 2017	1.306	1.420	18,5	21,8	1.080	1.270	730	790
IV. Annual averages								
2013	1.398		23,4		1.473		725	
2014	1.252		18,6		1.370		805	
2015	1.154		15,5		1.043		684	
2016 (projected)	1.209		17,3		931		619	

In Euro

	Gold		Silver		Platinum		Palladium	
I. Actual	1.188,4		17,2		982,6		623,8	
II. Gliding averages								
5 days	1.197,6		17,5		993,9		624,0	
10 days	1.201,7		17,7		1.014,8		625,8	
20 days	1.206,3		17,9		1.020,3		630,2	
50 days	1.193,9		17,4		968,3		575,0	
100 days	1.148,8		16,0		930,8		539,9	
200 days	1.096,5		14,7		874,8		514,3	
III. Projections								
	Range		Range		Range		Range	
	Low	High	Low	High	Low	High	Low	High
Q3 2016	1.058	1.189	15,8	17,6	766	1.018	577	631
Q4 2016	1.180	1.283	16,1	19,0	755	1.104	623	689
Q1 2017	1.279	1.390	17,8	20,9	1.040	1.220	700	760
Q2 2017	1.306	1.420	18,5	21,8	1.080	1.270	730	790
IV. Annual averages								
2013	1.052		18		1.108		545	
2014	949		14		1.036		611	
2015	1.045		14		945		619	
2016 (projected)	1.098		16		846		562	

Source: Bloomberg; own calculations. Projections of Degussa Goldhandel GmbH (end of quarter); numbers are rounded.

Articles in earlier issues of the *Degussa Market Report*

Issue	Content
19 August 2016	Debt Monetized En Masse to Fend Off the Euro Crash?
5 August 2016	No English issue due to summer break
22 July 2016	The Demise of the Interest Rate - the Comeback of Gold Money
8 July 2016	Escaping the Euro Trap
24 June 2016	The Credit Cycle and the Price of Gold
10 June 2016	US Fed wants to raise rates further - investors should cling to gold and stocks
27 May 2016	The Illusion of Central Bank Independence and the Consequence for the Gold Price
13 May 2016	The Fight Against "Secular Stagnation" and What It Means for Gold and Silver Prices
29 April 2016	US dollar dominance - challenged by gold
15 April 2016	A World without Returns
1 April 2016	Helicopter Euros Hovering on the Horizon
18 March 2016	Gold and stocks protect against 'helicopter-euros'

The Degussa Marktreport (German) and the Degussa Market Report (English) are available at:
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